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LEGISLATION

COMMENTS ON SELECTED SECTIONS OF THE 1954 INTERNAL REVENUE CODE—A SYMPOSIUM

DIVIDEND CREDIT AND EXCLUSION

Under the present tax laws corporate profits are allegedly taxed twice, once in the form of income to the corporation, and again in the form of dividend-income to the stockholder.¹ Section 34, which allows a credit against tax equal to 4% of dividends received, and Section 116, which permits the exclusion of the first \$50 of dividend income, were inserted in the 1954 Code to alleviate this "double taxation." Those favoring passage of the new sections argued that the measures were at least a step in the direction of eliminating this burden.² They also pointed to the dangers inherent in the disproportionate reliance by business on non-equity financing, precipitated by this oppressive treatment of dividend income.³

In taking the opposite position, opponents of the new provisions reasoned that the admittedly burdensome taxation of corporate earnings should merely be looked upon as an added cost of doing business in the corporate form.⁴ In their view, the corporation and the stockholder were two separate entities,⁵ and therefore there was no apparent, much less real, "double taxation." Accordingly, Sections 34 and 116 were not alleviating an unjust tax burden, but were in effect giving preferential tax treatment to a select group,⁶ by favoring unearned dividend income over earned income.⁷ Apart from the ques-

¹ 100 Cong. Rec. 8540 (June 28, 1954) (statement by Hon. Eugene D. Millikin, Chairman of the Senate Finance Committee, on bringing H.R. 8300 to the Senate floor for debate).

² 100 Cong. Rec. 11759 (July 28, 1954) (statement by Hon. Daniel A. Reed, Chairman of the House Ways and Means Committee, regarding the Conference Report on H.R. 8300).

³ See note 1 *supra*. Interest paid on its bonds is deductible by the corporation under Section 163, whereas dividends paid on its stock are not deductible. Hence, corporations rely to a larger extent on debt financing, than on equity financing, in order to escape the tax imposed on dividends.

⁴ See STANLEY AND KILCULLEN, *FEDERAL INCOME TAX* 19 (Pamphlet No. 1, 1954).

⁵ *Ibid.* See 1 MERTENS, *LAW OF FEDERAL INCOME TAXATION* § 9.01 (1942).

⁶ See H.R. REP. NO. 1337, 83d Cong., 2d Sess. B7 (1954) (Minority Report on H.R. 8300).

⁷ *Ibid.* Prior to 1943, "earned income" was given preferential tax treatment in order to grant relief to taxpayers in the small income brackets. "The

tion of loss of revenue, they opposed the measures as representing a basic change in our tax philosophy, *i.e.*, a shift from taxing according to one's ability to pay, to relieving those in the high income brackets and burdening those who are least able to bear it.⁸

The granting of tax relief to dividend income is not an innovation in the law of taxation. Canada has provided such relief since 1949,⁹ while England has granted it for over 100 years.¹⁰ Until 1936 there was little or no need for such relief in the United States, since dividend income was substantially tax free. Although dividends were included in gross income,¹¹ dividends received by an individual were exempt from normal tax.¹² The Revenue Act of 1936 eliminated this individual exemption but permitted corporate stockholders a credit of up to 85% of dividends received, when computing the corporation's normal tax.¹³ Under a similar provision in the present Code, corporate stockholders are permitted a deduction of up to 85% of dividends received from taxable domestic corporations¹⁴ and from certain foreign corporations.¹⁵ Prior to the 1954 Code, individual stockholders were taxed on the full amount of dividends received, since their pre-war exemption had been taken away and never restored. This led to the recent demand for relief from "double taxation" of dividend income which culminated in the passage of Sections 34 and 116, which are perhaps the most controversial measures in the new Code.

Effective with respect to taxable years ending after July 31, 1954, an individual stockholder is allowed a credit against tax of 4% of dividends received after July 31, 1954 from domestic corporations and included in gross income. However, the credit is limited to the lesser of the following amounts: (1) the total tax due for the taxable year as reduced by the foreign tax credit;¹⁶ or (2) 4% of the taxable income for the taxable year.¹⁷ It is to be noted that dividends ex-

1924, 1926 and 1928 Acts contained a 25% tax credit for earned income, but the 1932 Act eliminated this feature of the Revenue Act. The 1934 Act reinstated the earned income credit, and it was thereafter retained in the 1936 and 1938 Acts and the original enactment of the Internal Revenue Code. However, the Treasury Department finally recommended the repeal of the earned income credit, and its repeal by the 1943 Act apparently rang an everlasting death knell with respect to such a credit." 5 MERTENS, LAW OF FEDERAL INCOME TAXATION § 32.03 (1953).

⁸ See note 6 *supra*.

⁹ See P-H 1954 IRC Vol. p. 24,011.

¹⁰ See note 2 *supra*.

¹¹ Revenue Act of 1934, § 22(a), 48 STAT. 686 (1934).

¹² Revenue Act of 1934, § 25(a)(1), 48 STAT. 692 (1934).

¹³ Revenue Act of 1936, § 26(b), 49 STAT. 1664 (1936).

¹⁴ INT. REV. CODE OF 1954, § 243.

¹⁵ *Id.* § 245.

¹⁶ *Id.* § 34(b)(1).

¹⁷ *Id.* § 34(b)(2)(B). For taxable years ending before January 1955, the credit is limited to 2% of taxable income. *Id.* § 34(b)(2)(A).

cluded from gross income under Section 116 do not enter into the computation of the credit. The credit is also disallowed in the case of taxpayers who report their income on Form 1040A, in which the tax is computed by the Secretary or his delegate.¹⁸

An individual stockholder may exclude from gross income the first \$50 of dividends received from domestic corporations in a taxable year ending after July 31, 1954. Where a husband and wife each own stock, both are entitled to the exclusion (*i.e.*, \$50 each) whether they file joint or separate returns.

Since the dividend credit and exclusion were intended to eliminate double taxation, they only apply to situations in which double taxation would occur.¹⁹ Thus, in order for a dividend to qualify it must: (1) come from a corporation which is subject to the ordinary corporate tax, and (2) constitute a distribution which is taxable to the stockholder.²⁰ The credit and exclusion, therefore, are disallowed in the case of dividends from life insurance companies, China Trade Act Corporations,²¹ tax exempt charitable organizations, tax exempt farmers' cooperative associations²² and corporations engaged in business within the possessions of the United States governed by Section 931.²³ Dividends from foreign corporations are also ineligible. Interest payments, in the form of "dividends" from mutual savings banks, cooperative banks and domestic building and loan associations which are withdrawable on demand, do not qualify,²⁴ since they are deducted by the organizations themselves.²⁵ Similarly, dividends from mutual insurance companies (other than mutual marine and mutual fire insurance companies issuing perpetual policies) are treated as a return of capital and therefore ineligible.²⁶ Finally, the credit and exclusion are denied to those nonresident aliens who are not subject to the regular income tax, but who are taxed instead under Section 871(a).²⁷

Special rules have been formulated to cover partial interest cases and other problematical areas. In instances where the dividends are received by an estate or trust, the credit is allowed to the estate or

¹⁸ *Id.* § 6014.

¹⁹ See P-H 1954 IRC Vol. p. 24,010.

²⁰ Accordingly, the credit and exclusion do not apply to nontaxable dividends. However, taxable cash, property or constructive dividends, taxable stock dividends, taxable stock and bond rights, and certain liquidation dividends and stock redemptions qualify, if received from a corporation which is subject to the regular corporate tax. The new Code retains the general rule for determining the taxability of a corporate distribution. INT. REV. CODE OF 1954, § 301(c).

²¹ *Id.* §§ 34(c)(2), 116(b)(2).

²² *Id.* §§ 34(c)(3)(A), 116(b)(3)(A).

²³ *Id.* §§ 34(c)(3)(B), 116(b)(3)(B).

²⁴ *Id.* §§ 34(d)(1), 116(c)(1).

²⁵ *Id.* § 591.

²⁶ *Id.* §§ 34(c)(1), 116(b)(1).

²⁷ *Id.* §§ 34(e), 116(d).

trust only in respect to that portion of the dividend which is not properly allocable to any beneficiary.²⁸ The proportionate share of each participant in the amount of dividends received by a common trust fund is, for the purposes of Sections 34 and 116, considered as having been received by the participant.²⁹ Where the dividend is received by a partnership, the dividends are apportioned among the partners.³⁰ Dividends received from regulated investment companies are eligible to the extent that such dividends represent a distribution by the company of dividends received from corporations in which it has invested. The remaining portion of the dividend is a capital gain dividend and consequently does not qualify.³¹

Sections 34 and 116 will cause an estimated loss of revenue totaling 204 million dollars,³² with a corresponding saving to 7,100,000 stockholder-taxpayers.³³ The percentage of increase in the after-tax yield of dividend income will be comparatively small in the low income brackets, but will be rather sizable in the high income brackets. Under the old Code, for example, a taxpayer in the 20% bracket receiving \$100 taxable dividend income would have an after-tax yield of \$80. With the new 4% credit against tax, he will have an after-tax yield of \$84, an increase in yield of 5%. A taxpayer in the 91% bracket receiving \$100 in taxable dividend income formerly received only \$9 in after-tax dividend yield. As a result of the 4% credit, his after-tax yield will now be \$13, an increase of 44.4%.³⁴

²⁸ *Id.* § 642(a) (3).

²⁹ *Id.* § 584(c) (2).

³⁰ *Id.* § 702(a) (5).

³¹ *Id.* §§ 34(d) (2), 116(c) (2). If the dividends received by the investment company constitute more than 75% of its gross income, the investment company's stockholders may apply the credit and exclusion to the entire amount of dividends received by them. *Id.* § 854(b) (1). The investment company is required to notify its stockholders as to the amount which may be taken into account as dividends for the purposes of Sections 34 and 116, through a written notice mailed not later than 30 days after the closing of its taxable year. *Id.* § 854(b) (2).

³² See note 2 *supra*.

³³ See 100 Cong. Rec. 8537 (June 28, 1954) (statement by Hon. Eugene D. Millikin, Chairman of the Senate Finance Committee, on bringing H.R. 8300 to the Senate floor for debate). Nevertheless, as pointed out by the Minority Report on H.R. 8300, 92% of American families own no stock, while six-tenths of 1% of the population own 80% of all publicly held stock. See note 6 *supra*. Therefore, it is debatable whether the sections benefit the average taxpayer or unduly favor those in the higher income brackets. However, some relief may be justifiable and necessary in the case of small, closely-held corporations, in which the stockholders devote much of their time to the business of the corporation. Since this type of business organization is commonly utilized by small independent businessmen, remedial legislation in this area would not be open to the criticism that it favors a particular class or gives preferential treatment to unearned income.

³⁴ In these examples it is assumed that the taxpayer receiving \$100 under the new Code has already taken his \$50 exclusion. Therefore, the exclusion aspect is not considered. See P-H 1954 IRC Vol. ¶ 23,005 (This paragraph also includes an interesting analysis of the comparative tax advantages of

Apart from savings which will accrue from the normal operation of the statute, a stockholder may take advantage of the new provisions through affirmative action. Thus he might find it profitable to borrow money to invest in stock, since the interest payable on the loan is tax deductible, and the dividends received on the stock are eligible for the tax credit and exclusion.³⁵ It may also prove worthwhile to buy stock prior to the dividend-record-date and to sell it immediately after the ex-dividend date. The dividends received would qualify for the credit and exclusion, and the stockholder would also have a short-term capital loss, resulting from the sale of the stock after its market value had declined due to the payment of the dividend.³⁶

Although the relief granted under these sections is comparatively small, their enactment may foreshadow the return of substantially tax-free dividends and may encourage, to some degree, the use of equity capital.

CORPORATE ORGANIZATION

By the enactment of two provisions, Sections 351 and 248, the new Code has attempted to simplify certain tax problems which confront the organizers of a corporation. Each of these sections is designed to eliminate an area of confusion which had existed under the prior law.

Under the 1939 Code, as under the 1954 Code, the organizers of a corporation who transferred property to it were permitted, under certain circumstances, to acquire the corporate stock without incurring tax liability. For the transaction to enjoy tax-free status, however, the 1939 Code required that the stock be received by the organizers in substantially the same relative proportion as was the value of the property each had transferred to the corporation. If this "proportionate interest" did not exist, a gain or loss was recognized on the part of the organizer receiving a larger or smaller relative interest in the distributed securities than he had in the transferred property.¹

capital gains transactions and taxable and non-taxable bonds as compared with dividends eligible for the exclusion and credit.).

³⁵ See Zack, *How the New Code Will Affect the Individual Taxpayer*, 98 J. ACCOUNTANCY 294, 296 (1954).

³⁶ *Ibid.*

¹ INT. REV. CODE OF 1939, § 112(b)(5). Under this section, as under the 1954 Internal Revenue Code, Section 351(a), the transaction is not tax-free unless the transferors are in control of the corporation immediately after the transfer. In the 1954 Internal Revenue Code, Section 368(c), control is defined as "... the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation." This definition was carried over from the 1939 Internal Revenue Code, Section 112(h).

Considerable litigation ensued in an effort to determine whether or not such a proportionate interest existed in specific situations. Two different tests were applied in an effort to settle the question.² According to the "control" test, that percentage of all the transferred property which each organizer contributed was compared to the percentage of stock he received in all the stock distributed. Then, the difference in the percentages, if any, was compared to the differences which occurred in the case of the other organizers, to ascertain whether there was any substantial variance in the respective percentages. If there was, the requisite proportionate interest did not exist, and the transfer was taxable.³ Under the "relative value" test, on the other hand, the value of the property transferred by each organizer is compared with the value of property received by him. If a difference exists in any one instance, it is compared with the difference, if any, that existed in the receipt by the other organizer or organizers. This would result in a spread, which, if substantial, would cause the transaction to lose its tax-free status.⁴

The uncertainty engendered by the proportionate interest requirement has been eliminated, ostensibly at least, by Section 351 of the 1954 Code. The new section abandons the former approach to the problem, and seeks to base the tax upon the real nature of the transaction. Thus, where two or more organizers transfer property to a corporation, and one of them receives all the stock, no gain or loss will be recognized. If, however, the transfer is a subterfuge to conceal a gift or a payment for services from one organizer to another, it will result in tax liability.⁵

² See 2 CCH 1955 FED. TAX REP. ¶2503.17.

³ See *Ared Corp. v. Commissioner*, 30 B.T.A. 1080 (1934) (decided under Revenue Act of 1926, which employed the same language as the 1939 Code); see *Hartford-Empire Co. v. Commissioner*, 137 F.2d 540, 542 (2d Cir. 1943) (decided under Revenue Act of 1932, which was also similar to the 1939 Code provision). The operation of the "control" test may be illustrated by the following example: *A* and *B*, the only organizers of a corporation, each contributed \$10,000 to the corporation; *A* received back \$20,000 in stock and *B* received back \$15,000 in stock. *A* has received 57% of the total stock although he only contributed 50% of the total property. Conversely, *B* has only received 43% of the stock. Coupling *A*'s gain of 7% with *B*'s loss of 7%, it becomes apparent that there is a spread of 14%. If this spread were regarded by the court as indicative of a substantial disproportion, *A* would be taxed on a gain of \$5,000, this being the monetary value of the disproportion.

⁴ See *Bodell v. Commissioner*, 154 F.2d 407 (1st Cir. 1946); *United Carbon Co. v. Commissioner*, 90 F.2d 43 (4th Cir. 1937) (decided under Revenue Act of 1926, which employed the same language as the 1939 Code). If, in the same example used in note 3 *supra*, the "relative value" test were employed, account would be taken of the fact that *A* made a profit of 100% on the entire transaction, while *B* only made a profit of 50%. The spread between the two would therefore be 50% according to the "relative value" test, although it was only 14% according to the "control" test.

⁵ See H.R. REP. NO. 1337, 83d Cong., 2d Sess. A117 (1954); SEN. REP. NO. 1622, 83d Cong., 2d Sess. 264 (1954).

While Section 351 is a praiseworthy effort to simplify the Code, the practical value of the change can only be judged after the new provision has been litigated. Until then, the possibility remains that the new section will be construed in such a fashion that it will be quite as constricting as the former law. Indeed, it is difficult to envision a situation in which the organizers would receive widely disproportionate returns on their contributions, without a taxable gift or payment for services being made, in fact, from one of them to the other.⁶

Another provision, Section 248, corrects injustices which had existed in reference to the deduction of organizational expenses from taxable income. Under previous law, the regulations had provided that the expenses of organizing a corporation were capital expenditures, and therefore were not deductible from gross income.⁷ Attorneys' and accountants' fees, for example, were disallowed as business deductions because they were incident to corporate organization.⁸ However, prior to the enactment of the 1954 Code, the law recognized a single exception to the general rule that organizational expenses were not deductible. In the case of a corporation chartered for a term of years, it had been held that such expenditures might be amortized over the period of the corporate life,⁹ notwithstanding the possibility that the charter might be renewed and the life of the corporation prolonged.

Under the new Code, the corporation chartered in perpetuity is allowed, at its election, to treat organizational expenses as deferred expenditures over a period of five years or more.¹⁰ The expenses must be of such a nature, however, that they would have been amortizable under prior law if the corporation had been chartered for a term.¹¹ Commissions paid in connection with the sale of stock, for instance, were not amortizable even by a corporation with a limited life, since such expenses did not result in any increase of exhaustible

⁶ See Darrell, *Corporate Organizations and Reorganizations Under the Internal Revenue Code of 1954*, 32 TAXES 1007, 1008 (1954). Section 351 was undoubtedly intended to apply to newly organized corporations. By its terms, however, it also encompasses a transfer to an existing corporation by two or more individuals in return for corporate securities. In such a situation it would seem even less likely that a substantially disproportionate return on the transaction would be regarded by the Commissioner as anything other than a gift from one organizer to another.

⁷ U.S. Treas. Reg. 118, § 39.24(a)-2, 2 P-H 1954 FED. TAX SERV. ¶ 11,091-a (1953).

⁸ *Clarence Whitman & Sons, Inc. v. Commissioner*, 11 B.T.A. 1192 (1928); see *Appeal of F. Tinker & Sons Co.*, 1 B.T.A. 799, 803 (1925).

⁹ *Hershey Mfg. Co. v. Commissioner*, 43 F.2d 298 (10th Cir. 1930). Subsequently, however, the Board of Tax Appeals declined to follow the *Hershey* case. See *Wisconsin Land & Lumber Co.*, 1 P-H 1928-1932 BTA MEM. DEC. ¶ 32,239 (1932).

¹⁰ INT. REV. CODE OF 1954, § 248(a). The time and method of making the election is prescribed in U.S. Treas. Temp. Rules, ¶ 7, 19 Fed. Reg. 5497 (1954).

¹¹ See H.R. REP. No. 1337, 83d Cong., 2d Sess. A64 (1954).

capital assets.¹² Accordingly, they will not be deductible under Section 248.

Section 248 eliminates the previously existing bias toward the relatively few corporations which are chartered for a term of years, by extending the same tax treatment to all corporations. More important, however, is its realistic appraisal of organizational expenses as outlays incident to the conduct of a business. By permitting them to be deducted as amortizable expenses, the new Code recognizes the actual nature of such expenditures, especially in the situation where many corporations are employed in the operation of what is essentially a single enterprise.

RECEIPT OF STOCK DIVIDENDS

The power of Congress to tax the receipt of cash or property dividends is well established, but in the past considerable doubt existed as to its power to tax a stock dividend.¹ The question presented was whether the receipt of such dividend constituted taxable income. Only recently has it been argued by some that a tax on the receipt of stock dividends would not be declared unconstitutional.² Despite this view, however, the receipt of a stock dividend, with minor exceptions,³ is exempted from tax by the 1954 Internal Revenue Code.⁴

The Revenue Act of 1913 taxed dividends in general but made no specific reference to stock dividends.⁵ An attempt by the Commissioner to tax such dividends was frustrated by the Supreme Court in *Towne v. Eisner*⁶ where it was held that stock dividends were not "income" within the meaning of the Act. However, in the Revenue Act of 1916,⁷ a clause was inserted which expressly taxed stock dividends. Under this Act, a second attempt was made to tax stock divi-

¹² *Surety Finance Co. v. Commissioner*, 77 F.2d 221 (9th Cir. 1935); *Barbour Coal Co. v. Commissioner*, 74 F.2d 163 (10th Cir. 1934).

¹ See PRASHKER, CASES AND MATERIALS ON THE LAW OF CORPORATIONS 603 (2d ed. 1949).

² See Lowndes, *The Taxation of Stock Dividends and Stock Rights*, 96 U. OF PA. L. REV. 147, 149 (1947); Rottschaefer, *Present Taxable Status of Stock Dividends in Federal Tax Law*, 28 MINN. L. REV. 163, 192 (1944).

³ Distributions are taxable when they are in lieu of money, i.e., "... in discharge of preference dividends for the taxable year of the corporation in which the distribution is made or for the preceding taxable year ..." or where the shareholder has an election to receive the distribution in money or stock. See INT. REV. CODE OF 1954, § 305(b).

⁴ "... [G]ross income does not include the amount of any distribution made by a corporation to its shareholders, with respect to the stock of such corporation, in its stock or in rights to acquire its stock." *Id.* § 305(a).

⁵ 38 STAT. 167 (1913).

⁶ 245 U.S. 418 (1918).

⁷ 39 STAT. 757 (1916).

dends, in the celebrated *Eisner v. Macomber* case.⁸ The Court held, however, that the Revenue Act of 1916 was unconstitutional in so far as it taxed stock dividends. The decision was based on the nature of a stock dividend⁹ in relation to the concept of "income" as used in the Sixteenth Amendment.¹⁰ In ascertaining the nature of a stock dividend, the Court concluded that nothing of value is received by the shareholder. By the very nature of a stock dividend, no gain is derived from the shareholder's investment capable of being severed from the corporation and put to the stockholder's own use.¹¹

The *Macomber* case was broadly interpreted by the Congress and, as a result, when the Revenue Act of 1921 was enacted, all stock dividends were exempted from income tax.¹²

Sixteen years later, in a series of cases beginning with *Koshland v. Helvering*,¹³ the Supreme Court held that a stock dividend was income where the shareholder's proportionate interest in the corporation was altered by the distribution. In the *Koshland* case, a holder of preferred stock received voting common stock, giving him new voting rights in the corporation.¹⁴ Receipt of this stock dividend was considered income even though the shareholder's assets remained in the corporation. Thus the narrow concept of "income" expounded in *Eisner v. Macomber* was expanded by the *Koshland* case.

Soon after the *Koshland* case was decided, the Revenue Act of 1936¹⁵ became law. Pursuant to that Act, stock dividends were exempted to the extent that they did not "... constitute income to the shareholder within the meaning of the Sixteenth Amendment. . . ." ¹⁶

⁸ 252 U.S. 189 (1920). The case was decided by a divided Court, Justices Holmes and Brandeis each writing a dissenting opinion, joined by Justices Day and Clarke respectively. It was promptly criticized by the majority of law review writers of the day. The articles are cited in *Helvering v. Griffiths*, 318 U.S. 371, 373 n.4 (1943).

⁹ See *Eisner v. Macomber*, 252 U.S. 189, 208-212 (1920).

¹⁰ *Id.* at 206-208.

¹¹ The shareholder, in reality, merely receives evidence of his newly adjusted interest in the corporation. The Court regarded the stock dividend as the final stage in a plan which enabled the corporation to retain surplus assets while it seemingly distributed those assets to its shareholders. The plan is to pay for additional stock out of surplus and distribute this stock to shareholders as a dividend. Each shareholder owns no more than he owned prior to distribution. Nor is value received, since the shareholder's assets are still subject to the corporation's control. See note 9 *supra*. For various definitions of income, see SURREY AND WARREN, *FEDERAL INCOME TAXATION* 185-196 (1954).

¹² 42 STAT. 228 (1921).

¹³ 298 U.S. 441 (1936). See *Helvering v. Sprouse*, 318 U.S. 604 (1943); *Helvering v. Gowran*, 302 U.S. 238 (1937).

¹⁴ "A stock dividend may change the stockholders' proportionate interests because it effects a change in: (1) voting rights; (2) participation in profits; (3) priorities to assets on liquidation; or (4) proportionate ownership of the corporation." Lowndes, *The Taxation of Stock Dividends and Stock Rights*, 96 U. OF PA. L. REV. 147, 150 (1947).

¹⁵ 49 STAT. 1648 (1936).

¹⁶ 49 STAT. 1688 (1936).

With the disappearance of the unqualified freedom from taxation previously enjoyed by stock dividends, and in light of the inroads made on the *Macomber* rule by the proportionate interest cases, the Treasury Department thought the time was ripe in 1943 for a direct attack on the exemption of stock dividends. It was believed that the complexion of the Supreme Court had changed to the extent that *Eisner v. Macomber* would not be followed if a similar case were presented.¹⁷ In *Helvering v. Griffiths*¹⁸ an attempt was made to tax a distribution of common stock to holders of common. Again, the stock dividend was held non-taxable but this time the decision was not based on constitutional grounds. Discussion of the nature of a stock dividend in relation to the meaning of "income" was conspicuously absent. The stock dividend was held not taxable on the sole ground that Congress had not declared it taxable. It was intimated that had Congress expressly imposed a tax on stock dividends a contrary result would have been reached.¹⁹

It is possible that stock dividends no longer enjoy tax exemption on constitutional grounds.²⁰ In that event, it would appear that the exemption given them by Congress in the 1954 Code is a limitation which the Government has imposed upon itself. The reason for this exemption may be that the tax is merely postponed.

In addition to reaffirming the *Macomber* rule, the new Code has overturned the line of cases which held that stock dividends were taxable where the distribution altered the shareholder's proportionate interest in the corporation. It is submitted that the change is an improvement. The shareholder's changed proportionate interest does not seem to be a logical basis of distinction between taxable and non-taxable stock dividends.²¹ In reality, the shareholder realizes no gain whether his interest is altered or not. In the usual case the changed proportionate interest, and the new rights that accompany it, mean little to the shareholder. Again, the stock dividend does not increase the shareholder's assets nor relieve his funds from the hazards of corporate use. Thus it would appear that where a stock dividend is distributed it is the realization of a profit on sale that is important to the shareholder. The 1954 Code has, accordingly, postponed the imposition of the tax until the sale or similar disposition of the stock.²²

¹⁷ See, e.g., PRASHKER, CASES AND MATERIALS ON THE LAW OF CORPORATIONS 603 n.1 (2d ed. 1949).

¹⁸ 318 U.S. 371 (1943).

¹⁹ "Of course, if there were an adequate basis in statute and regulation for the tax in question, it is difficult to understand why its collection should be regarded as 'harassing.' . . . [W]e may well inquire why the legislation should not precede the judicial decision." *Id.* at 404.

²⁰ See note 2 *supra*.

²¹ See Lowndes, *The Taxation of Stock Dividends and Stock Rights*, 96 U. OF PA. L. REV. 147, 155-157 (1947) for a general discussion of this view.

²² See Cohen, Silverman, Surrey, Tarleau and Warren, *The Internal Revenue Code of 1954: Corporate Distributions, Organizations and Reorganizations*, 68 HARV. L. REV. 393, 405 (1955).

GOVERNMENT-INSURED LOANS

Congressional investigations during the past year have focused public attention upon scandals associated with the Federal Housing Administration.¹ Bold headlines revealed the multi-million dollar profits realized by builders capitalizing on a "loosely-written law."² This problem had its genesis during the acute postwar housing shortage when, in an attempt to alleviate this condition, Congress enacted legislation providing for government-insured mortgage loans.³

A variety of devices were soon employed to take advantage of the shortcomings of the law. The most popular device was to apply for a sizeable government-insured mortgage loan, build an apartment project for less than the loan, and declare a dividend on the excess amount.⁴ Since the difference between the amount of the insured mortgage and the actual cost of the housing project did not represent payments from earnings and profits, and since proceeds of a loan are not income, the dividends paid out of this sum were not taxable as ordinary dividends.⁵

The shocking revelations of tremendous windfall profits moved Congress to utilize tax legislation as a deterrent to such sharp practices. Undoubtedly the most direct remedy would have been to strengthen the federal housing legislation and to provide for more stringent enforcement of existing regulations. Congress, however, decided to add Section 312(j) to the 1954 Internal Revenue Code.⁶

The statute is grounded upon the principle that distributions from earnings and profits are taxable to the shareholder as ordinary dividends.⁷ When Section 312(j) is applicable, fictional earnings and profits are created at the time of distribution. This is best illustrated

¹ See Newsweek, Nov. 8, 1954, p. 28, col. 1; Time, Oct. 18, 1954, p. 19, col. 2; U.S. News & World Report, Oct. 22, 1954 p. 35, col. 1.

² See U.S. News & World Report, *supra* note 1, at p. 40, col. 3.

³ *Ibid.*

⁴ See Newsweek, *supra* note 1, at col. 2.

⁵ Government attempts to tax these distributions as ordinary dividends have not met with success. See George M. Gross, 23 T.C. — (1955).

⁶ "(j) DISTRIBUTION OF PROCEEDS OF LOAN INSURED BY THE UNITED STATES.—

(1) IN GENERAL.—If a corporation distributes property with respect to its stock, and if, at the time of the distribution—

(A) there is outstanding a loan to such corporation which was made, guaranteed, or insured by the United States (or by any agency or instrumentality thereof), and

(B) the amount of such loan so outstanding exceeds the adjusted basis of the property constituting security for such loan, then the earnings and profits of the corporation shall be increased by the amount of such excess. . . .

(2) EFFECTIVE DATE.—Paragraph (1) shall apply only with respect to distributions made on or after June 22, 1954."

⁷ See 3 P-H 1955 FED. TAX SERV. ¶ 34,048.

by a hypothetical. A corporation receives a government-insured mortgage loan of \$1,000,000 and erects an apartment house at the cost of \$900,000. It thereupon distributes the \$100,000 difference to its shareholders. This amount is not earnings and profits. Section 312(j), however, declares that just prior to such distribution the earnings and profits are increased by the amount of the difference between the loan and the adjusted basis.⁸ Thus, this distribution will be from earnings and profits, by use of this statutory fiction, and as such will be taxable as ordinary dividends. Immediately after this distribution the earnings and profits will be decreased by the amount added, that is, \$100,000.⁹

The regulations issued by the Treasury Department indicate that such decrease will not reduce the earnings and profits below zero.¹⁰ Thus, the distribution in the above hypothetical would not cause a deficit against which *future* earnings and profits could be charged. If in the second year the corporation realized actual earnings and profits of \$50,000, this amount would not be charged against a \$100,000 deficit. If there is a distribution of this \$50,000, the dividends are taxable as ordinary dividends.

A more difficult problem is presented by distributions, other than from earnings and profits, made by the corporation after it has distributed its loan excess. For example, during the first year a corporation has distributed \$100,000, the difference between the amount of the loan and the adjusted basis. During the second year it distributes another \$100,000, not from earnings and profits, but from paid-in surplus. The proposed regulations construe the language of the statute in such a manner that Section 312(j) would again apply and the dividends would be taxable as ordinary dividends. Thus, immediately prior to such distribution, the \$100,000 difference between the loan and the adjusted basis (if no part of the loan has been repaid) would be added to the earnings and profits and the distribution would be deemed derived from those earnings and profits and taxable at this rate.¹¹

The employment by Congress of its powers of taxation to correct abuses arising in the administration of other laws and in the functioning of governmental agencies is at best questionable. The net result is to make more complicated a field of law beset by complications of its own. It is to be hoped, however, that this new section will serve as an effective deterrent to the perpetration of similar frauds.

⁸ INT. REV. CODE OF 1954, § 312(j).

⁹ *Ibid.*

¹⁰ U.S. Treas. Temp. Rules, § 1.312-12, 19 Fed. Reg. 8252 (1954).

¹¹ *Ibid.*

SALE OF TREASURY STOCK

When a corporation sells shares of stock, whether it be formative stock or non-formative, issued at some later date, no gain or loss is recognized for tax purposes.¹ In such matters it is of no consequence that the stock was sold at a premium² or at a discount.³ In this respect, the 1954 Code has not added anything new, but only reiterates that which has long been recognized.

Unlike the sale of original stock, the law concerning the sale of treasury stock has been conflicting and unclear. The difficulty arose in determining whether or not a corporation realizes a taxable gain or a deductible loss when it sells shares of its own stock that it had previously reacquired from a stockholder. The 1939 Code contained no specific provision pertaining to this problem, nor did any of the previous revenue acts. The Commissioner, however, did make applicable provisions in the various tax regulations interpreting the different revenue acts and the 1939 Code. These provisions have in no way been consistent.

The first such regulation, promulgated after the Revenue Act of 1916, made any gain accruing to a corporation from the sale of its treasury stock taxable.⁴ However, following the Revenue Act of 1918, the Commissioner reversed his position, and the regulations provided that such gains were not taxable.⁵ This continued to be the rule until 1932 when a court refused to give the regulation carte blanche effect. In *Commissioner v. S. A. Woods Machine Co.*,⁶ the court stated that "[w]hether the acquisition or sale by a corporation of shares of its own capital stock gives rise to taxable gain or deductible loss depends upon the real nature of the transaction involved."⁷ The court then proceeded to lay down the following test. "If it was in fact a capital transaction, i.e., if the shares were acquired or parted with in connection with a readjustment of the

¹ "No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation." INT. REV. CODE OF 1954, § 1032(a).

² *Farmers & Merchants State Bank*, 2 B.T.A. 130 (1925); see *Emerson Electric Mfg. Co.*, 3 B.T.A. 932, 935 (1926).

³ *Simmons Co. v. Commissioner*, 33 F.2d 75 (1st Cir.), cert. denied, 280 U.S. 588 (1929); *Corning Glass Works v. Lucas*, 37 F.2d 798 (D.C. Cir. 1929), cert. denied, 281 U.S. 742 (1930) (Where a corporation pays a commission to a broker or bank to aid in selling such stock, then such commission is not deductible; it is considered as selling the stock at a discount.). For an analogous situation where such commissions are considered part of the purchase price, see N.Y. STOCK CORP. LAW § 69.

⁴ See *Commissioner v. Rollins Burdick Hunter Co.*, 174 F.2d 698, 699 (7th Cir. 1949).

⁵ *Ibid.*

⁶ 57 F.2d 635 (1st Cir.), cert. denied, 287 U.S. 613 (1932).

⁷ *Id.* at 636.

capital structure of the corporation . . . ,”⁸ then it is not taxable. “But where . . . a corporation has legally dealt in its own stock as it might in the shares of another corporation, and in so doing has made a gain or suffered a loss, we perceive no sufficient reason why the gain or loss should not be taken into account in computing the taxable income.”⁹

In 1934, the Commissioner adopted the above test and incorporated it in the regulations.¹⁰ The courts were quick to adopt this rule.¹¹ Difficulty, however, arose as to its application. The Tax Court gave it a literal interpretation, and looked to the time of purchase and the reasons surrounding it. If the stock was reacquired for the purpose of changing the capital structure of the corporation, but for one reason or another that purpose failed, and the stock was again distributed at a profit, then it was not a taxable transaction.¹² The courts of appeals, however, refused to adopt such a narrow interpretation. Instead of viewing the transaction at the time of repurchase, they were concerned only with the subsequent distribution and whether or not it gave rise to a change in the capital structure.¹³ If there were no resulting changes in the capital framework, then any profits on the resale were subject to an income tax.¹⁴

It was because of this uncertainty and confusion that Congress enacted Section 1032(a) of the 1954 Code.¹⁵ Under this new section, it is no longer necessary to inquire into the transaction to determine the reasons for the repurchase, or even to determine whether there is a change in capital. Rather, the new section is absolute on its face, and recognizes neither a gain nor a loss resulting from the sale of treasury stock, regardless of the circumstances surrounding the repurchase or the subsequent resale. Thus, the law has again done a

⁸ *Ibid.*

⁹ *Ibid.*

¹⁰ See note 4 *supra*.

¹¹ The 1934 regulation was held not to be retroactive since the prior regulations had acquired the force of law. *Helvering v. R. J. Reynolds Tobacco Co.*, 306 U.S. 110 (1939). It was held to apply prospectively, however. *Commissioner v. Air Reduction Co.*, 130 F.2d 145 (2d Cir.), *cert. denied*, 317 U.S. 681 (1942). See also *United States v. Stern Bros. & Co.*, 136 F.2d 488 (8th Cir. 1943); *Brown Shoe Co. v. Commissioner*, 133 F.2d 582 (8th Cir. 1943).

¹² See *Cluett, Peabody & Co. v. Commissioner*, 3 T.C. 169 (1944); *Brockman Oil Well Cementing Co. v. Commissioner*, 2 T.C. 168 (1943); *Dr. Pepper Bottling Co. v. Commissioner*, 1 T.C. 80 (1942).

¹³ See *Commissioner v. H. W. Porter & Co.*, 187 F.2d 939 (3d Cir. 1951); *Commissioner v. Rollins Burdick Hunter Co.*, 174 F.2d 698 (7th Cir. 1949). However, in *Anderson, Clayton & Co. v. United States*, 122 F. Supp. 837 (Ct. Cl. 1954), *cert. granted*, Sup. Ct., Feb. 7, 1955, the court, in reviewing the positions of the Tax Court and courts of appeals, decided in favor of the former. The court expressed the opinion that there was some doubt as to whether a corporation's purchasing and selling of its own stock is not really a capital transaction.

¹⁴ See note 13 *supra*.

¹⁵ See SEN. REP. NO. 1622, 83d Cong., 2d Sess. 426 (1954).

complete about-face and has returned to the position adopted after the Revenue Act of 1918.

The enactment of Section 1032(a) marks a distinct advancement in this field of tax law. The tax lawyer is greatly aided in that the uncertainties have been removed and he may advise his clients with greater certainty as to the law governing such transfers. The corporation is aided in that no longer is it penalized in the form of taxation, when, having repurchased its stock in a purely capital transaction, it is for some reason subsequently required to resell it.¹⁶ It has also been suggested that the new provision will be more in keeping with established accounting practices.¹⁷

DECLARATIONS OF ESTIMATED INCOME TAX BY CORPORATIONS

Under the 1954 Code, a corporation whose tax for the taxable year "can reasonably be expected to exceed \$100,000,"¹ must file a declaration of estimated tax on September 15 of the taxable year.² The "estimated tax" is computed by subtracting \$100,000 from the expected tax liability.³ In addition, the corporation is required to make partial tax payments during the same taxable year, namely in two equal installments on September 15 and December 15.⁴ The remaining tax liability is paid when the corporation files its return on March 15⁵ of the following year, or, if the corporation elects, in two installments on March 15 and June 15.⁶ The Code permits a certain flexibility with regard to the payments during the taxable year. Since the amount of those payments depends on the September 15 estimate, if the tax outlook should change after that date, the declaration will be amended and the December 15 payment increased or decreased accordingly.⁷ Moreover, if a corporation does not, until after

¹⁶ See note 13 *supra*. See also P-H 1954 IRC VOL. ¶23,003 (for a discussion of the benefits received by a corporation under this section).

¹⁷ See *Commissioner v. Air Reduction Co.*, 130 F.2d 145, 148 (2d Cir.), *cert. denied*, 317 U.S. 681 (1942) (dissenting opinion).

¹ INT. REV. CODE OF 1954, § 6016(a) [applicable to all corporations "... subject to taxation under section 11 or 1201(a), or subchapter L of chapter 1 (relating to insurance companies) ..."].

² *Id.* § 6074. For purposes of illustration, the dates mentioned in this article refer to calendar-year corporations. The same rules apply to fiscal-year corporations. Thus, the filing date for a fiscal-year corporation is the fifteenth day of the ninth month of the taxable year, with the dates for tax payments adjusted accordingly.

³ *Id.* § 6016(b).

⁴ *Id.* § 6154(b). The corporation may elect to pay these installments on earlier dates. *Id.* § 6154(e).

⁵ *Id.* §§ 6072(b), 6151(a).

⁶ *Id.* §§ 6152(a)(1)(B), 6152(b)(2).

⁷ *Id.* § 6154(c). Amendments can be made if the original declaration was filed before December 15. *Id.* § 6074(b).

August 31, expect a tax liability to exceed \$100,000 it will merely file its declaration on or before December 15⁸ and make its full estimated tax payment then.⁹ There is no requirement for the filing of a declaration when a corporation does not reasonably expect, until after December 1, that its tax liability will exceed \$100,000. It should be noted, however, that these provisions relating to declarations of estimated tax "... apply only with respect to taxable years ending on or after December 31, 1955."¹⁰

Thus Congress, for the first time, is applying to corporations a pay-as-you-go system which, for individual taxpayers, had its inception in 1943.¹¹ One problem involved in enacting a pay-as-you-go system is getting the plan started: how to avoid burdening the taxpayer with payments for the current year under the new plan in addition to the tax payments for the previous year under the prior system. The 1943 Act solved the problem by in effect excusing, in most cases, payment of the prior 1942 tax.¹² The 1954 Code, however, excuses no taxes, but works at a gradual shift, over a period of years, to the pay-as-you-go system whereby the burden of extra payments is reduced to a minimum. For example, in 1955, a corporation (whose tax is expected to exceed \$100,000) will, in addition to paying its 1954 income tax on March 15, pay in September and December a total of 10% of its 1955 estimated tax.¹³ Thus, the corporation is, in effect, compelled to pay more than its 1954 tax liability in *calendar year 1955* (100% of the 1954 tax plus 10% of the 1955 estimated tax).¹⁴ While the corporation is not actually paying an additional tax, the plan has the effect of withdrawing its liquid assets to the extent of 10% of its next year's estimated tax—money it could formerly use for current business expenses. Each successive year after 1955 the amount of tax to be paid during the taxable year is increased

⁸ *Id.* § 6074(a).

⁹ *Id.* § 6154(b).

¹⁰ *Id.* § 6016(f).

¹¹ Current Tax Payment Act of 1943, 57 STAT. 126 (1943). The main provisions of this Act (as amended), in regard to declarations of estimated tax for individuals, were incorporated into Sections 58, 59 and 294 of the 1939 Code.

¹² 57 STAT. 145-149 (1943), repealed, 58 STAT. 73 (1944). "Since taxpayers for the first time were expected to pay the current year's taxes from current earnings, it was generally considered necessary to give some relief during the conversion period. Persons having taxes in excess of \$50 for 1942 paid a tax in 1943 consisting of the greater of the 1942 or the 1943 taxes plus 25 per cent of the lesser tax. Those individuals having a 1942 tax of less than \$50 were forgiven the lower of the 1942 or the 1943 taxes." Koch and Moore, *Income Taxes and Their Impact on the Individual Since 1913*, 32 TAXES 462, 464-465 (1954). See also Keesling, "The Pay-As-You-Go Plan," 18 J.B.A. CALIF. 224, 233-236 (1943).

¹³ INT. REV. CODE OF 1954, § 6154(a).

¹⁴ It should be noted that the corporation is not paying 10% of its actual 1955 tax, but 10% of its 1955 estimated tax, which includes the \$100,000 exemption. *Id.* § 6016(b).

by 10% until 1959 when it reaches 50%.¹⁵ The transition will be fully accomplished in 1960, when the corporation will pay the remaining 50% of its 1959 tax and 50% of its 1960 estimated tax.

Prior to the Revenue Act of 1950, a corporation paid its taxes for the taxable year in four equal installments, on March, June, September and December 15 of the following year.¹⁶ In order to accelerate the collection of revenue, the Revenue Act of 1950 provided for the gradual increase in the percentage of total tax payments due on March 15 and June 15 until the September and December payments were completely eliminated.¹⁷ This change-over from four to two installments was completed for the taxable year 1954. The 1950 Act thus made possible the 1954 Code pay-as-you-go system which requires two payments of estimated tax during the current taxable year. Congress felt that a four-installment system, *i.e.*, payments of the prior year's tax in March and June and payments of the current year's tax in September and December, makes easier the management of the public debt. Moreover, the installment system under the Revenue Act of 1950, in lumping tax payments between March and June, aggravated "the effect of Treasury operations on the money markets."¹⁸ While corporations having an expected tax of less than \$100,000 will still continue on a two-installment system, the pay-as-you-go plan, with four installment payments, will affect 20,000 corporations accounting for 85% of corporate income taxes.¹⁹

Unlike the complicated penalties provided for pursuant to the pay-as-you-go system for individuals under the prior Code,²⁰ the 1954 Code merely charges corporations a 6% penalty on underpayments.²¹ Moreover, the Code realistically makes allowances for business fluctuations which might make it difficult to precisely predict the estimated tax. Thus no penalty is imposed on underpayments if they were based on an estimate which was not below 70% of the actual tax.²² The Code also dispenses with penalties if certain prescribed

¹⁵ *Id.* § 6154(a).

¹⁶ INT. REV. CODE OF 1939, § 56(b). This section was amended by the Revenue Act of 1950. See note 17 *infra*.

¹⁷ Revenue Act of 1950, § 205(a), 64 STAT. 929-930 (1950). See SEN. REP. NO. 2375, 81st Cong., 2d Sess. (1950) in 2 U.S. CODE CONG. SERV. 3053, 3069-3071 (1951).

¹⁸ See H.R. REP. NO. 1337, 83d Cong., 2d Sess. 102 (1954). Under the two-installment system, the Government, to obtain current funds, sold interest bearing, short-term securities to taxpaying corporations, who in buying them in effect made advance payment of their income taxes. The four-installment system will make funds available to the Government with less need to rely upon sale of such securities. *Ibid.*

¹⁹ See SEN. REP. NO. 1622, 83d Cong., 2d Sess. 139 (1954).

²⁰ INT. REV. CODE OF 1939, § 294(d). See H.R. REP. NO. 1337, *supra* note 18, at 100-101 (for a discussion of the complexities of these penalty provisions).

²¹ INT. REV. CODE OF 1954, § 6655(a). Wilful failure to pay estimated taxes is a misdemeanor punishable by fine (of not more than \$10,000 plus the cost of prosecution) and imprisonment (not more than one year) or both. *Id.* § 7203.

²² *Id.* § 6655(b).

systems are used to estimate the tax.²³ Finally, while the Code provides that corporations which reasonably expect their tax liability to exceed \$100,000 must file a declaration of estimated tax, no penalty is prescribed for failure to do so.²⁴ The only penalty is for actual underpayment of estimated tax.



APPORTIONMENT OF THE NEW YORK STATE ASSEMBLY

Introduction

On January 5, 1955, Governor Averell Harriman presented his first annual message to the New York State Legislature.¹ In his message, he called the legislature's attention to the glaring distortions in the apportioning of the Assembly.² The Governor recommended "... the initiation of a Constitutional amendment to remedy the injustices of our present apportionment system," by apportioning members on the basis of population.³

The present procedure for apportioning representatives in the Assembly is governed by Article III, Sections 2 and 5 of the New York State Constitution. Section 2 provides, in part, that "[t]he assembly shall consist of one hundred and fifty members."⁴ There is no flexibility in the number of assemblymen to be apportioned, as there is in the case of senators.⁵ This restrictive provision, as will

²³ Thus, no penalty for underpayment is assessed if the estimated tax upon which the payments were based: (1) amounts to the previous year's tax (minus \$100,000); or (2) equals what would have been the previous year's tax liability (minus \$100,000) if it were computed according to current tax rates; or (3) equals at least 70% (after subtracting \$100,000) of the tax that would be due on the basis of current income up to a specified cut-off date. *Id.* § 6655(d).

²⁴ See 4 CCH 1955 FED. TAX. REP. ¶ 5552. Section 294(d)(1)(A) of the 1939 Code prescribed penalties for failure to file a declaration of estimated income.

¹ 1955 LEG. DOC. No. 1.

² The Governor posed as an example of such distortion the fact that "Schenectady County contains ten times as many citizens as Schuyler County, yet each is represented by a single Assemblyman." *Id.* at 21.

³ *Id.* at 21.

⁴ N.Y. CONST. Art. III, § 2.

⁵ Article III, Section 2 of the New York State Constitution provides that the Senate shall consist of fifty members, except that an increase in this number may be allowed in accordance with the provisions of Section 4, where "... any county having three or more senators ... shall be entitled ... to an additional senator [for each full ratio over three]." See *Matter of Dowling*, 219 N.Y. 44, 113 N.E. 545 (1916).